Economic Outlook

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Forecasting the economy is often a dicey exercise, but the year ahead has some unusual twists that make the process especially interesting. A shift toward fiscal restraint as well as certain aspects of tax reform next year will tend to suppress economic growth, while auto sales and housing starts already show signs of sputtering. These considerations would tend to put the economic expansion on a fragile footing next year. At the same time, exports are now responding favorably to the substantial decline in the dollar against major currencies since early 1985 and will likely continue to improve next year as well. Moreover, since inflationary pressures remain relatively subdued and since reductions in personal income tax rates due to tax reform will be phased in next year, real disposable personal income will continue to show moderate growth and provide support for consumer spending. The likely result will be a shift in the composition of economic growth. Some manufacturing industries that are now seeing a turnaround will continue to have rising sales and production, while domestic auto sales will likely weaken. Real GNP is expected to rise 3.5% from the fourth quarter of this year to the fourth quarter of next year, following an estimated 2.7% rise this year.

Industrial production has essentially moved sideways for slightly more than two years now. Conditions seemed to deteriorate earlier this year, with the sharpest month-to-month declines since the last recession recorded in February and March, but production has improved since then. As of September, the total index was 1.4% higher than the March level and 0.8% higher than a year ago. Production in several industries is still lower than a year ago, with the sharpest decline in oil and gas extraction by a wide margin. Other industries, however, have begun to emerge from the doldrums.

Paper production rose 9.6% from August 1985 to August 1986, compared to a decline of 0.6% in the prior 12-month period. Production in the textile industry this August was 8.9% higher than a year ago and 18.1% higher than the level at the end of 1984. The textile industry had in effect gone through another full recession in 1984, even as the overall economy continued to expand. The rebound in textile production is the result of the completion of the inventory correction in the retail apparel industry that began in 1984. It also shows the effects of quotas, though certainly not to the extent desired by the industry. The chemical, furniture, and appliance industries are also showing greater strength in production, while aircraft production has consistently been a strong performer. Nevertheless, conditions still remain soft for numerous other manufacturing industries. Even for these, however, September's substantial 3.4% rise in new orders, which are admittedly notoriously volatile, suggests that more industries will be experiencing a turnaround, to some extent because of the depreciation of the dollar.

In summary, the economy faces numerous obstacles next year, but some industries that had slowed down have now gotten a second wind. As it enters its fifth year, the current expansion is indeed at what would historically be considered an advanced age. In past expansions, however, inflation would be enough of a problem at this point so that monetary policy would be turning increasingly restrictive. Today, with the underlying rate of inflation still low and likely to remain relatively low, it is likely that the economy will continue to expand for several more years.

Bernard Schoenfeld

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Economic Forecast

Percent Changes at Annual Rates

	Actual			1986				1987	Actual	Forecast	
	I	II	III	IV	I	II	III	IV	1984-1985	1985-1986	1986-1987
Gross National Product	6.2	2.6	5.7	7.6	7.3	7.8	8.1	7.4	6.2	5.5	7.1
Real GNP	3.8	0.6	2.4	4.1	3.5	4.1	3.8	2.7	2.7	2.7	3.4
GNP Price Deflator	2.5	1.8	3.6	3.1	3.7	3.6	4.2	4.5	3.4	2.8	3.5

	Actual	Forecast	Actual	Forecast	
	1986:III	1986: IV	1984-1985	1985-1986	1986-1987
Consumer Spending	10.2%	3.3%	7.1%	6.2%	6.4%
Durable Goods	44.9	-11.7	8.5	7.3	4.3
Nondurable Goods	3.1	4.7	4.0	3.3	3.9
Services	6.8	6.9	8.9	7.9	7.4
Business Capital Spending	3.2	7.5	10.0	0.8	2.6
Structures	-5.3	1.7	11.1	-7.0	-1.9
Equipment	7.1	10.1	9.4	4.8	4.7
Residential Investment	11.2	10.9	5.7	13.2	8.5
			1985	1986	1987
Change in Invertories	$-7.5b.	$20.0b.	$11.1b.	$17.7b.	$32.3b.
Net Exports of Goods and Services	$-110.1b.	$-112.2b.	$-78.9b.	$-105.1b.	$-91.5b.
			1984-1985	1985-1986	1986-1987
Government Purchases	4.5%	7.5%	11.2%	5.9%	7.0%
Federal	-2.1	6.2	13.7	3.1	6.5
Defense	-2.0	6.2	10.4	6.3	6.5
Other	-1.8	5.5	24.3	-5.7	6.4
State & Local	9.6	8.4	9.3	8.0	7.5
Corporate Profits Before Tax	1.2*F	0.5*	-5.3	3.6	7.3
Corporate Profits After Tax @	-6.7*F	-10.0*	-6.3	-5.6	4.1
Plant and Equipment Expenditures	3.0F	6.0	9.2	-2.0	2.0
Real Final Sales#	4.6	2.0	4.2	2.5	3.2
Real Disposable Personal Income	-2.2	3.1	2.3	3.3	3.3

Economic Indicators	Recent Data			Actual	Forecast	
	July	Aug.	Sept.	1984-1985	1985-1986	1986-1987
Consumer Price Index**	0.0%	2.4%	3.6%	3.7%	2.1%	4.1%
Producer Price Index for Finished Goods**	-4.8	3.6	4.8	2.1	-2.4	3.7
Industrial Production	0.6	0.1	0.1	2.2	1.1	2.5
Retail Sales**	0.7	1.5	4.6	6.4	6.4	5.8
				1985	1986	1987
Auto Sales (millions of units, a.r.)	10.7	12.7	16.1	11.1	11.2	10.6
Housing Starts (millions of units, a.r.)	1.78	1.82	1.68	1.74	1.86	1.70
Unemployment Rate	6.9%	6.8%	7.0%	7.2%	7.0%	6.5%
Merchandise Trade Deficit (a.r.)	$216.4b.	$159.9b.	$150.7b.	$148.5b.	$170.0b.	$145.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

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#GNP less change in inventories, both in real terms.
**Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).
$b. = billions a.r. = annual rate F = Forecast
@ Estimated to include loss of investment tax credit beginning in 1986.